

Success or Failure? Current Account Problems in the Baltic States

Gábor Kutasi¹

Abstract: The economic story of emerging Baltic countries seemed to be a success before 2007. The region has seemed to be very disciplined in fiscal and monetary sense since their independence, besides, produced a boosting economic growth and significant real convergence to the higher developed EU members. But these countries with balanced policies suffered sudden stop in 2007. If fiscal balance, debt sustainability and fixed exchange rate is secured, what else can undermine the growth potential? The hypothesis is that the process of income growth and quick catching-up of Baltic economies were established on external financing. Baltic countries can be complied to the political economy model of macroeconomic populism. The analysis is based on the macroeconomics of the Feldstein-Horioka puzzle and the reverse Balassa-Samuelson effect. The paper examines terms of trade, NEER, REER, ULC, current account imbalance, inflation and savings to conclude on reasons sudden stop in the Baltic region. Through the Baltic example, the paper enlightens on a structural problem of the European integration.

Keywords: Baltic states, external imbalance, macroeconomic populism, Feldstein-Horioka puzzle, reverse Balassa-Samuelson effect

JEL: F32, F36, F41, G01, H60

1. Introduction

The economic story of emerging Baltic countries seemed to be a success before 2007. Small open economies with sustainable and low public debt, five-eleven percent permanent annual GDP growth rate, accession to the EU, and getting rid of the Soviet economic heritage. The region has seemed to be very disciplined in fiscal and monetary sense since they became independent. In the first half of 2000s they even produced a boosting economic growth and significant real convergence to the higher developed EU members. The region has proved to be attractive for capital investment. However, economic analyses have projected some structural problems in their external (im)balance. These countries with balanced policies suffered sudden stop in 2007, what was even strengthened by the global crisis. If fiscal balance, debt sustainability and fixed exchange rate is secured, what else can undermine the growth potential? Behind the fine indicators considered to be important, the external imbalance of the Baltics showed increasing deficit year by year. Finally, the external indebtedness problem undermined the sustainable growth. Besides, the Baltic convergence signaled, too, the imperfection of the Baltic economic success. The currency board based economic policy produced more than excellent public finance and debt numbers which are directly under the influence of policy makers. But the inflation as an indirect result indicator of policy brought series of failure in monetary integration. This chapter examines the origins of sudden stop and the failure in price stability aspirations. External imbalance caused by passive macroeconomic populism gets under test now in case of Baltic economies.

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In the single European market, it seems that the individual external balance of member states became neglected aspect. In the catching-up member states with inflation beyond the average, the single central bank rate proved to be too low in the sense that credit was very cheap and it was preferable to spend in the current present instead of saving for future. This counter-selection of single monetary policy will be important as Baltic states current account deficit was accumulated through foreign currency (euro) credits. Thus not the national, but the single central bank rate mattered to the market. Meanwhile, the Baltic way of monetary convergence with strictly pegged foreign exchange caused unadjustable real appreciation, since it has been working as a peg toward the core countries with single currency within the EU. This characteristic ruined the Baltic wage competitiveness by increasing wage demand because of higher inflation. The additional inflation and the increasing wages were originated in external credit money creating additional demand. The relatively cheap credit – which a priori originated from non-local sources – financed mostly consumption of imported products and services. This could have happened until any of the global financial actors were willing to seek risky emerging market items. The Baltic recession situation – originated in the external indebtedness – reveals the trap of those periphery countries in the euro zone which wasted the single currency advantages to finance the cheap import from foreign private credit. The currency board countries can not neither devalue their currency to improve the current account nor have the public debt to depreciate through inflation without damage of monetary and fiscal credibility. (Kutasi, 2012:717-718)

In the Baltic case, where euroization of credit market was supported by policy makers, thus loosing a significant part of influence on monetary processes, the Baltic private debtors calculated with the euro rates. The multi-level inflation with a single interest rate of ECB has preferred the countries with higher as a counter-selection in the loan market, but for their fate, this also has discouraged the private savings in these countries. It can be followed in time series of effective exchange rate and unit labour cost that their has been real appreciation in the member states with high inflation in comparison to ones with low inflation, in the single currency zone without any local monetary intervention. Calculation is used to show the real appreciation problem of Baltic countries against the lower-inflation ones, in the single currency zone without any effective monetary intervention in a currency board regime. This Reverse Balassa-Samuelson impact would have been motivation for excessive intra-community import in externally indebted countries. The survey on less and less competitive wage of countries suffering from real appreciation is an explanation for loss of competitiveness in their export and for relative cheapness of import.

2. Relation between macroeconomic populism and external indebtedness

Political economy of macroeconomic populism

Dornbusch and Edwards (1989:2-5 and 1991:7), concluding from their Latin American observations, understood the macroeconomic populism as the heterodoxy of economic policy making. Namely, when the economy gets wind for a while, the policy makers start to do such policy actions which make them popular in short term. But it does not mean simply spending money. The paradigm of macroeconomic populism results interim increase in living standards through macroeconomic stimuli, just like excessive fiscal and credit policy and overvalued currency. The core element of the paradigm is the redistribution to get development without social conflicts. Meanwhile, the populists neglect the importance of the risk of inflation, the risk from deficit financing, the external constraints and the reaction of global market actors on non-market-like policies. This approach can result a short term growth and recovery period.

Nevertheless, the policy makers ignore the fiscal and external constraints, and these bottlenecks cause recession and crisis in the medium term, as the constraints make the heterodoxy unsustainable. Finally, the long term outcome of macroeconomic populism will be the '*plummeting of real wages*', '*severe*' difficulties in balance of payment, '*galloping inflation*', crisis and the '*collapse of economic system*'. These "developments" will enforce austerity and demand for external (IMF) aid. The authors emphasize the role of external imbalance (Dornbusch and Edwards;1991:7-8)

Based on the observations by Darvas and Szapáry (2008) describing the economic trends and risks in the Eastern EU member states, Csaba (2008) discovered a similar but different kind of macroeconomic populism in the EU10 region. (Besides, the Southern members – Greece, Italy, Portugal, Spain – can mentioned as bad practices of the Latin American kind of macroeconomic populism, as it was observed e.g. by Neményi and Oblath (2012) or Kutasi (2013).) Neményi and Oblath (2012: 596) that not only those countries got into trouble, who have been under excessive deficit procedure of the Community. Baltic sudden stop in 2007 or the Slovenian indebtedness problems in 2012 appeared in countries with sustainable budget balance. Divergence in inflation, competitiveness and relative wage cost was already observable among the euro zone countries.² Unlike the Latin American active populist policy, Csaba (2009: 111-112) determines the '*new kind*' of macroeconomic populism as a passive policy making by delaying reforms and unleashing private demand financed by loan. Unlike, again, the Latin American heterodoxy, Csaba (2008:602) establishes, that the new kind correctly follows the simplified models of '*elementary economic textbooks*'. This characteristic is originated in the European economic circumstances, where typically there are no significant opportunities for rent seeking in public finances from natural row material resources. That is why, the European version of populism can mostly affect passively on living standards by not levying more taxes in the revenue channel or not blocking the private consumption in the regulation channel. This will result a short term '*boom driven by the private sector and personal consumption*'. Csaba (2008:603)

The initial condition of the macroeconomic populism is to have dissatisfaction of people and politicians about national economic performance in stagnation and expectations for better dynamics. Many times, public opinion connects the stagnation to earlier disciplined austerity in the spirit of conservative economics. In the first phase, as written by Dornbusch and Edwards (1991:11 and 1989:6-7) in their four phases model, the policy makers refuse the restrictive conservative paradigm, ignore the macroeconomic constraints, as there is a temporary possibility to loosen the policy conditions. The quick result of pegged foreign exchange, fiscal expansion, credit expansion, tax cuts etc. can be the high growth of real wages. Although, it ruins the export competitiveness, the government is not willing to devalue the foreign exchange to avoid the inflation shock and the damage of living standards. But, in the second phase, the mentioned constraints as bottlenecks block the ongoing dynamic growth. The third phase is called the case when there are '*pervasive*' shortages, accelerating inflation, foreign exchange gap (overvaluation), which characteristics initiate capital flight, demonetization in real economy transactions, increasing public deficit and after all unsustainable populist policy. Dornbusch and Edwards (1989) emphasize the role of external destabilization and vulnerability in the process of heterodoxy failure. Than comes the orthodox stabilization as phase 4.

Both Dornbusch and Edwards (1989) about the active and Csaba (2008) about the passive populism established, that the mix of populist policy, external world economy and

² For example, the cumulated growth of ULC (unit labour cost) between 1999 and 2006 was 1,5% in Germany, but 25,2% in Greece, 23,2% in Spain, 27,7% in Portugal. (Neményi & Oblath 2012: table 1)

macroeconomic contexts result such an unsustainable economy where several elements get uncontrollable by policy makers. Control can be lost over inflation, current account deficit, public debt, crediting, money supply and monetary processes.

To implement the paradigm of populism to the case of Baltic states, the passive kind of macroeconomic populism model can be implemented. As Darvas and Szapáry (2008) established about the Baltic countries, beside the high speed of growth of 2000-2006, they accumulated high annual current account deficit, their pegged foreign exchange strengthened the price convergence, and in 2007 they got into recession with high inflation. Also, it was recognized, that the euroization of their credit market (52-77%) got significant. (Darvas & Szapáry, 2008:847) This characteristic severely reduced the influence of monetary policy on monetization, on the other hand, it proves the passivity of the populist policy. The euro credit got so popular, as it was based on the EURIBOR rate, much below the Baltic rates. It also had positive economic results in form of interest rate convergence that could verify the policy makers' passivity. Darvas and Szapáry (2008:855) even supplement the origin of reduced monetary transmission by mentioning the competition in the banking sector in the years of 2000s which also lowered the credit rates.

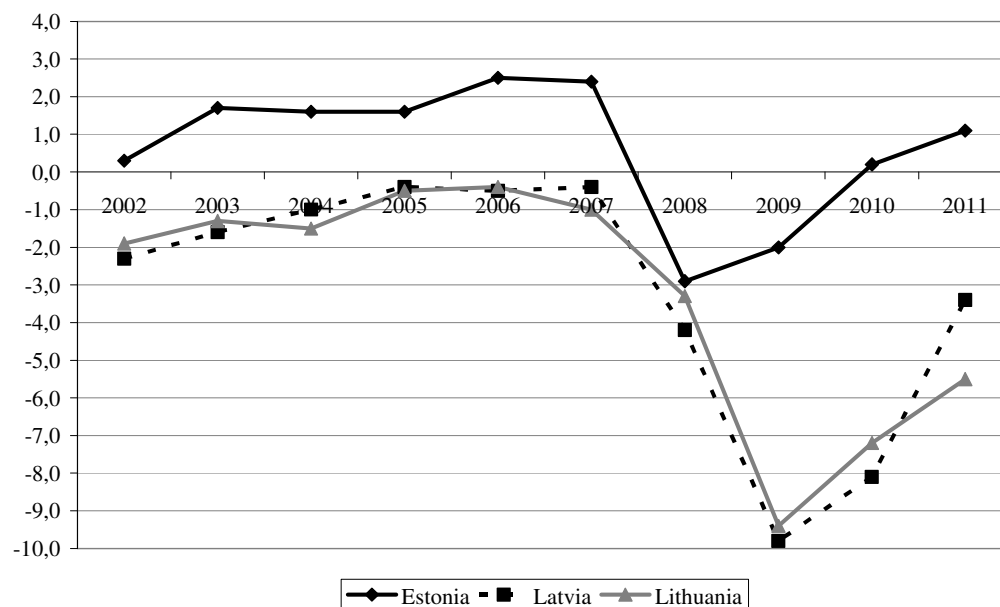
The phases of macroeconomic populism described by Dornbusch and Edwards (1991) is valid for the Baltic countries, too. The Soviet era and the first half of 1990s were the period of strongly repressed consumption, thus, the households desired more. The growth period of the region, and as global financial instruments made it possible (see below Feldstein-Horioka puzzle), that significant share of Baltic consumption and investment got financed from foreign sources. Of course, politicians did not want to obstruct the increase of welfare from external credit as it raised the placidity of people. Besides the toleration of low monetary transmission, the Baltic policies targeted low public duties. Csaba (2008) summaries the failure of macroeconomic populism in the Baltic (and East-Central European) region as follows: (1) cuts on public duties, (2) passivity in overheated economy, (3) focus only on fiscal balance, (4) delay of structural reforms, (5) no political consensus, (6) winner-takes-it-all behavior in politics, (7) elemental brake-through of private demand after decades of repressed consumption. This process caused an enormous current account deficit and high inflation (see below Reveres Balassa-Samuelson effect). Finally, bottlenecks appeared in the Baltics, too.

Exchange rate policy aspects

The Baltic internal economic balances originated in the primacy of monetary policy which targeted exchange rate stability first of all. In case of Estonia and Lithuania, the currency board system has been applied, and the Latvian monetary policy also targeted pegged rate with some adjustment cases. The purpose of the currency board is to copy the price stability of the reference (key currency) country/region. The Baltic monetary policies hoped to adjust the national price stability to the one in euro zone by pegging. The currency board is a quasi single currency position as there is no exchange rate volatility at all (toward the euro), and actually the monetary policy is very strictly bounded without room for non-harmonized maneuver by the exchange rate target. The national currency is pegged rigidly to the key currency and the peg becomes the anchor of economic policy as a primary target. The price stability will be a necessity to keep the relative purchasing power of the national currency. Basically the currency board is credible, if the national inflation keeps pace with the reference region. Of course, the economic policy instruments are also usable for exchange rate stability. Namely, the higher central bank rate through the interest rate parity can strengthen the demand for the national currency, or the public budget surplus through the purchasing power parity can reduce the commodity market demand and the inflation to keep the foreign exchange peg. (The peg has been 15.6466 EEK and 3.4528 LTL to 1 EUR.) It is concluded from the interest rate parity model that the policy on interest rate and money supply must be

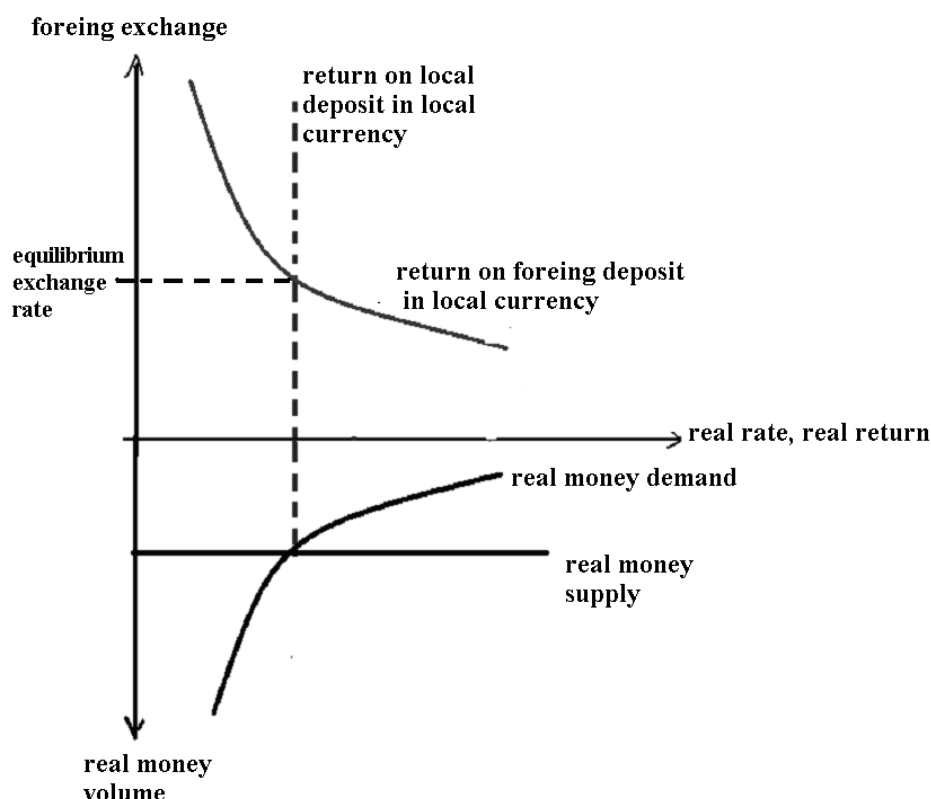
subordinated to the rigid target of foreign exchange. (see figure 2) Moreover, for the financial market equilibrium depending on GDP and real interest rate, the equilibrium of money demand and supply must be controlled by the fiscal revenue and spending items. In case of emerging countries, like the Baltics, the inflationary impact from Balassa-Samuelson effect should be buffered in the way of public distraction from private demand. (see figure 1)

Figure 1 Budget deficit of Baltic countries, percentage of GDP



Source: Eurostat

Figure 2 Context of interest rate parity



Source: author based on Krugman & Obstfeld (2002)

The full pegging can be advantageous only beside credible economic policy, but even fundamentals are correct, the peg still can endanger the economic growth. In case of overvaluation, the wage competitiveness of the economy using currency board deteriorates badly in the international trade. This can result fall in export revenue. Meanwhile, the local households perceive increasing real income since the overvaluation and start to increase their import consumption. Thus, pegging can cause contraction after a temporary economic boost. Both the South-East Asian currency crisis in 1997 (Krugman & Obstfeld 2002) and the Baltic recession in 2006-2008 (IBRD 2007) gives empirics to this thesis. In both cases, strong deterioration of external balance and sharp slow-down of economic growth were observable. Because of danger on competitiveness, the countries with peg find themselves on the horns of a dilemma: Namely, do they want to reserve their monetary credibility by insisting on the peg, or devalue to improve the competitiveness and thus the external balance.

The Latvian pegging has been very close to the currency board. Since 2005, Latvia has participated in the ERM II system, with a special individual unilateral commitment, namely that the Bank of Latvia guaranties a +/- 1 percent floating margin. The central peg haven't been changed since 2005, it is 0.702804 LVL to 1 EUR and the volatility has been kept in the guaranteed margin.³

As Baltic countries use strict pegging, their case has been very similar to the single currency zone members in sense of external adjustment without revaluation of foreign exchange. When it comes to examine the intra-community movement of products, services and transfers in a quasi single currency situation, the object of study is a quasi homogeneous money market, just like the gold standard system or the gold coins of middle ages. In case of currency board,

³ source: www.ecb.int, www.bank.lv

only technical exchange costs had differed the Estonian krooner and the Lithuanian litas from the euro. In the sense of exchange value, the quasi single currency is as homogeneous in the intra-zone trade as the global value of gold. This case can be surveyed two ways. The first way based on nominal adjustment. In case of assumption of nominal adjustment, the flexible price level mechanism or the automatic monetary mechanism can be used to explain the balance of payment procedures in a homogeneous international money market situation. (Szentcs, 1999) In this approach built on theory of David Hume and Milton Friedman, the expectations say, if there is external imbalance, it means that volume of euro is accumulated in a part of the euro states, the rest of the euro states will accumulate the products. The excessive money supply and absence of products in the countries with trade surplus should cause increasing local price and, thus, bigger demand for import from the countries with trade deficit as the latter ones have shortage of money and excessive product supply, thus, decreasing price level expressed in the quasi single currency. The flexibility mechanism has not worked. As there has been commitment to avoid flexible exchange rate mechanism, there has been no monetary adjustment against external imbalance in the Baltic countries. It can be established that Baltic economies has “desired” the single currency – Estonia already achieved it in 2010, Lithuania can introduce it in 2014 – thus in their strictly pegged rate system, there is no monetary autonomy. Besides, there are tax differences and fiscal differences in comparison to other euro zone countries. Moreover, labor market imperfections exist. Thus the assumption of perfect equilibrium and the distortion-free movements of factors and commodities are missing from the practice, however the neoclassical model is based on them.

The second way based on real adjustment can be a starting approach for further analysis of pegged-zone imbalances. This is built on the Keynesian automatic income adjustment mechanism. It focuses on the imbalance of savings (S) and investment (I), and it derives the current account (CA) from imbalance of trade, capital market and public sector.

$$Y = C + I + G + X - IM, \quad (1)$$

where Y is the output, C is the household consumption, G is public consumption, X is export, IM is import. From this equations savings looks like the following:

$$S = Y - C - T, \quad (2)$$

where T is tax revenue of the government. T is equal with G if there is budget balance, but obviously, in Baltic practice it is preferable to calculate with robust surplus or slight deficit.

$$X - IM = (S - I) + (T - G) \quad (3)$$

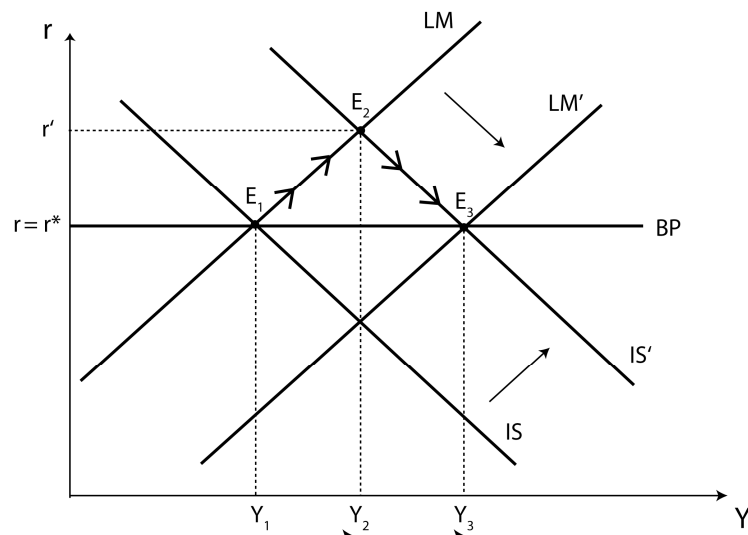
$$CA = S - I + \text{Budget Balance} \quad (4)$$

From equation 4, the Keynesian conclusion is that if there is current account deficit, adjustment can happen only through real terms. Namely, savings must be raised – parallel consumption decreases, – or investments must be decreased, or public budget should show less deficit/more surplus. (Szentcs, 1999; Afonso & Rault, 2010) From public finances view the public savings with the Baltic surpluses or sustainable deficits are appropriate, but the difference of private savings and investments are in massive deficit ($S_{\text{private}} - I_{\text{private}} < 0$).

There is an advanced eclectic model of the Keynesian IS-LM model approach on external balance, which is called the Mundell-Flemming model. In case of externally indebted countries in a quasi single currency zone, the version with pegged foreign exchange rate and fiscal expansion is relevant. (See figure 3) In the theoretical model, the assumed process is that the fiscal expansion shifts the IS-curve right/up, the IS-LM equilibrium moves from E_1 to E_2 . This results higher interest rate, thus, capital influx. To protect the pegged foreign

exchange, the monetary policy must extend the money supply, so LM-curve is pushed right/down, and equilibrium gets to E_3 . This result higher output (Y_1 to Y_3).

Figure 3 Fiscal expansion in Mundell-Flemming model in case of pegged foreign exchange



Source: Benczes & Kutasi (2010: figure 2.9/b)

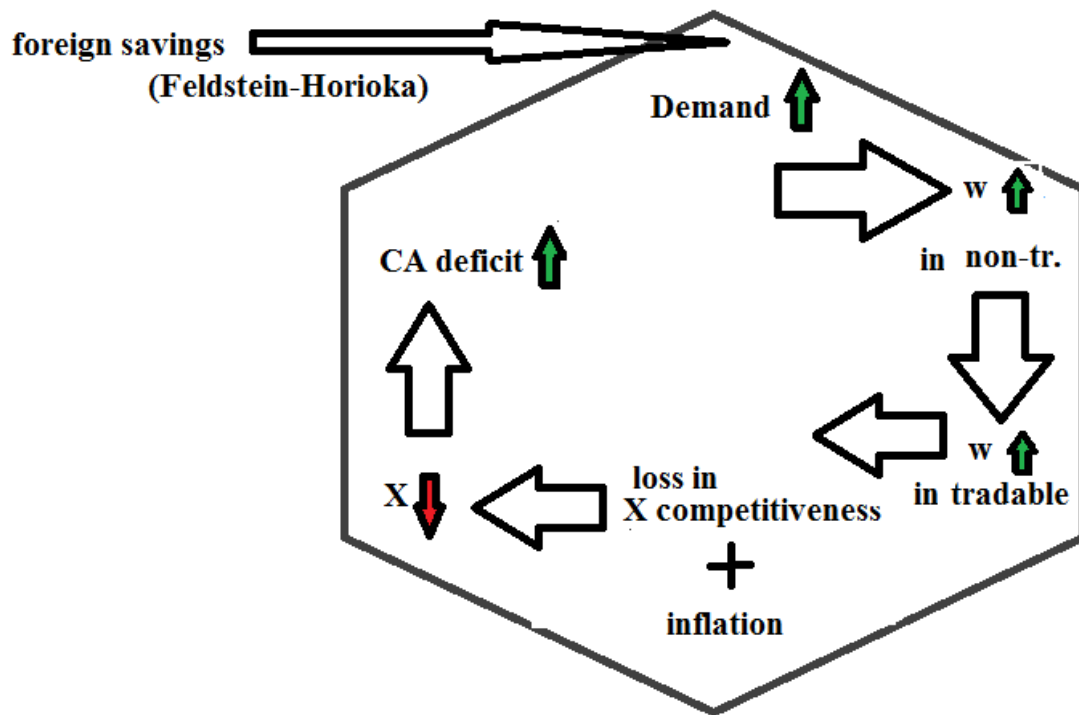
But why does not the model version work in case of European (quasi) single currency pegging practice? As it is described in the optimum currency area model by Mundell (1961), McKinnon (1963) and Kenen (1969), the national economies can adjust individually to asymmetric shocks in an economic community by flexible factor market, monetary policy or community funds. The factor markets are not perfect, especially the workforce mobility in the EU. The monetary policy is community competence in the euro zone, namely, it is not able to consider asymmetric impacts in its action. Only fiscal instruments remains, but most of the fiscal actions must be done by the national level, as there is no significant fiscal redistribution in the monetary community level.⁴

Recession model of external imbalance

It is worth to emphasize, that in an open economy, it is very likely that savings and investments correlate very weakly to each other, unlike in a closed economy assumed by Keynes where savings and investments assumed to be equal. Obstfeld and Rogoff (1996), in their 'new open economy model', emphasized the phenomenon of free international movement of national savings, thus, the free international financing of investments, what is called Feldstein-Horioka puzzle (see Feldstein & Horioka 1980). According to the Feldstein-Horioka puzzle, Afonso and Rault (2008) stated that, if savings and investments are not correlated, the budget deficit and the current account deficit "*tend to move jointly*".

Figure 4 Mechanism of Reverse Balassa-Samuelson effect in a national economy

⁴ The Community budget – involving the transfers for members out of euro zone, too – amounts to 1.1 percent of EU GDP. The MacDougall Report (MacDougall, 1977) estimated 5% of Community GDP as a minimum necessity for effective federal fiscal actions. The financial stability mechanism (EFSM) with 60 billion EUR, the financial stability facility (EFSF) with 440 billion EUR and the stability mechanism (ESM) with 500 billion EUR is altogether approximately 8% percentage of whole EU GDP but set apart as a guarantee fund for several years instead of an annual redistribution fund.



Demand: demand of consumption, *w in non-tr.*: wage level in non-tradable sector, *w in tradable*: wage level in tradable sector, *X*: export, *CA*: current account; white arrows show the causal relations, grey arrows show change of variable (↑ means increase, ↓ means decrease)

Source: Kutasi (2013: Fig.1)

As there has been neither individual devaluation nor federal bail-out mechanism, the unsolved external imbalance can result divergence, regression and degradation of externally indebted countries. This is the so called Reverse Balassa-Samuelson effect. (see Grafe & Wyplosz 1997; Jakab & Kovács 2000:144). The original Balassa-Samuelson effect derives the higher inflation of catching-up countries from the development of productivity in the catching-up tradable sector which causes wage increase and thus inflation pressure in the non-tradable sector. (Balassa 1964) The Reverse Balassa-Samuelson effect means that the relative change of price leads to divergence of productivity in the following way: In the euro zone, the quick convergence of interest rate imposed overheating in consumption in periphery economies of the euro zone. The expectations of households based on sharply decreasing interest rate were unfounded, but resulted quick private indebtedness particularly through consumption of non-tradable services. This latter impact raised the wage demands in the local non-tradable sector what spilled over to the tradable (export) sector. Thus, the export competitiveness deteriorated, meanwhile the local inflation rose by the higher wage cost. (Mongelli & Wyplosz 2008; Neményi & Oblath 2012)

Moreover, Lane and Perotti (1998), Beetsma et al. (2008), Benetrix and Lane (2009) found that the increasing public spending in the euro zone countries shifted the demand toward the non-tradable sector what resulted increasing wages logically there. Namely, the fiscal processes contributed to the emergence of Reverse Balassa-Samuelson effect. However, Lane and Milesi-Feretti (2002) found limited correlation between public debt and external imbalance in high developed countries.

According to De Santis and Lüthmann (2006) and Gavilán et al. (2011) the current account is determined by the following factors:

- The demography impact on the structure of consumption and savings. (Ando & Modigliani, 1963)
- Real GDP growth and its impact on savings (Modigliani, 1970) or on consumption based on future income (Tobin, 1967; Farrell, 1970)
- International competitiveness based on REER.
- Stages of development, as there is a U-shape relation assumption between CA balance and relative per capita income.
- Positive correlation between money stocks to GDP and savings. (Edwards, 1996; Chinn & Prasad, 2003)
- The continuity/smoothness of growth of labor productivity. (Glick & Rogoff, 1995)
- The inherited debt, called “original sin”.
- The effect of transparency on lower risk.
- Restrictions on current account and capital account, for example capital control.
- Deviation from uncovered interest rate parity.
- Portfolio impact, namely, sometimes the investors sell their low risk bonds with high yield to counterweight their loss on risky bonds, thus rebalance their portfolio. (Bohn & Tesar 1996)
- Market valuation impact, namely, how are the investment products overvalued according to P/E and fundamental value ratio.
- Effect of size of a company or a country. (Banz, 1981; Asness et al., 1997; Bekaert et al., 1997) The less capitalized country pays higher return.
- The investment and capital demand of national industries.
- The external financing demand and crowding-out impact of the public finances.
- The impact of crisis through GDP contraction, negative wealth shock on saving assets, increasing public spending and the end of plenty of international credit money.

There are some currency union practices in the world economy to prevent external imbalance problem inward the single market without fiscal union. In the CFA-franc zones (WAEMU and CAEMC), there are two-level hierarchy of criteria. Among the primary criteria, the external balance is as follows: ‘Non-accumulation of domestic and external payment arrears.’ Namely the government should not fall behind in its payment of interest and principal on debt to lenders more than in the previous year. Among the secondary criteria, there is exact rule for external deficit that can not exceed 5 percent of GDP. Besides, there is an indirect criterion prescribing 20 percent minimum for the ratio of domestic financed investments per tax revenue. (Dore & Nachega, 2000; Hadjimichael & Galy, 1997) This latter criterion reflects on explained Feldstein-Horioka puzzle, namely, the huge difference between local savings and investments. The Gulf Monetary Cooperation launched by the members of Gulf Cooperation Council has criteria very similar to the Maastricht criteria and an extra one about the foreign reserves. It prescribes that foreign reserves must be at least equal with the last four months import value. (Al Kholifey & Alreshan, 2010)

3. Development of Baltics in transition and integration periods

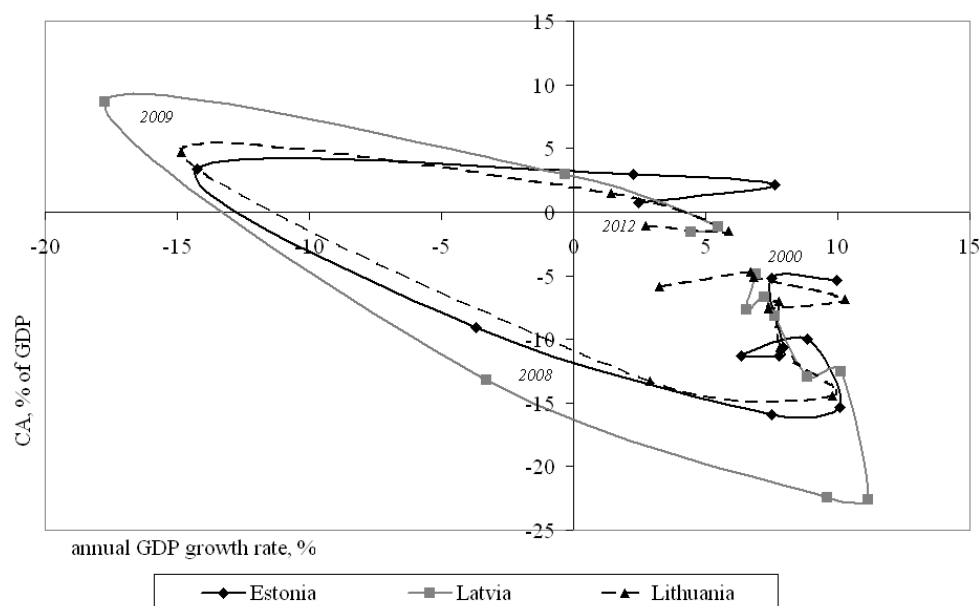
Minimal state with fiscal discipline

After the collapse of the Soviet Union, one of the limited number of advantageous heritage of Baltic countries was the very low level of public debt around 5 percent of the GDP. This could have created a robust room for maneuver for fiscal populism, however, the Baltic governments avoided to use it to the fiscal easing and political populism. This opportunity was utilized to reform the system of social services and shift the Baltic society and economy toward a liberal (Anglo-Saxon) social model with private financing.⁵ The economic growth

⁵ About liberal social model see: Sapir (2005)

and the welfare were based on influx of foreign direct investments and other capital sources. Nevertheless, the public balance and the monetary stability were not enough to bring a quick success in the monetary integration, as they had not enough impact on inflation. Since companies and households have accessed to cheap foreign loan, non of the budget surpluses and central bank rates could control and restrict the national consumption and investment and their impact on inflation. Keeping on missing the inflation target criterion, the Baltic monetary integration slowed down. Meanwhile, their euroization got to high level through loans. In the end of 2006, the financial euroization of loan market was approximately 52 percent in Lithuania, 76 percent in Latvia and 79 percent in Estonia. (Chitu, 2012:chart1) These data strengthens the thesis that monetary transmission has been very week in the Baltics. Figure 5 shows the connection between income growth and current account of Baltic economies. Between 2000 and 2006/2007 these countries had regionally outstanding growth, beside, extremely negative and deteriorating current account balance. Only GDP contraction shock could have the Baltic economies to break the deteriorating trend of external imbalance. The global shortage of credit money enforced the three economies to give up the import financed from debt. However, after the annual flow surpluses of contraction years, namely 2009-2010, as economic growth returned to the region, current account turned into a moderate deficit, again.

Figure 5 Baltic GDP growth in percentage and Current Account in percentage of GDP, 2000-2012



Source: IMF World Economic Outlook, 2012 October

The thesis, that these economies were overheated by foreign money can be verified by output gap data. E.g., the Estonian output gap was massively positive (beyond the potential) before the global crisis. (see table 1)

Table 1 Output gap of Estonia, percentage of potential GDP, period of 2000-2012

2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011f	2012f
-1.661	-1.174	-0.649	-0.186	-0.321	2.497	7.198	10.868	4.946	-9.797	-7.62	-1.579	-0.979

Source: International Monetary Fund, World Economic Outlook Database, October 2012

The overheated economy was just particularly originated in external loans, but also in tax cut competition among the Baltic fiscal policies, and the business cycle strongly synchronized with the Russian economy which boosted by the oil price boom of 2002-2007.

The global financial crisis hid a default risk from foreign exchange rate originated in the pegged rate and currency board regimes. The peg motivate market actors to get indebted in euro with lower reference rate. From table 2, it is legible that all actors of Estonian economy borrowed money almost always in foreign currency. Figure 6, on one hand, represents the acceleration of foreign credit demand of Lithuanian economy. On the other hand, it is clear, that the financial sector was the main channel of foreign credit promotion, as most of capital import was composed from foreign credit channeled in by monetary financial institutions (namely banks) and financial corporations.

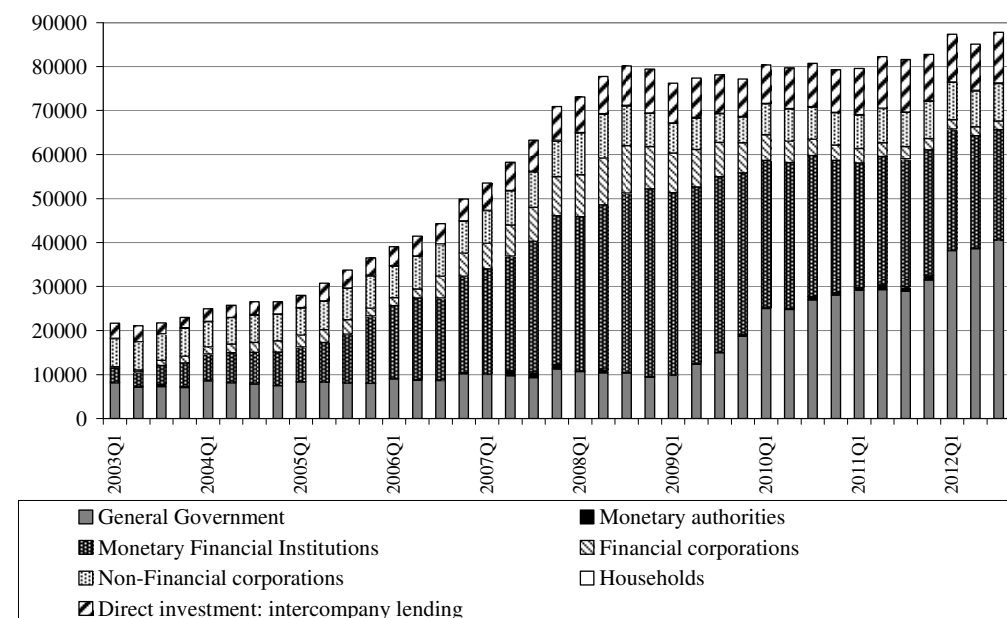
Table 2 Share of foreign currency (mostly euro) loan from all in case of resident actors in Estonia

	2004	2005	2006	2007	2008	2009	2010
Government	80,09%	80,41%	74,23%	74,06%	87,59%	92,02%	94,53%
Financial Institutions	97,48%	98,50%	92,50%	94,16%	98,12%	98,88%	93,90%
Non-financial comp.	78,78%	75,98%	75,66%	78,02%	86,23%	89,96%	93,18%
Households	65,01%	75,08%	77,83%	77,32%	82,26%	83,94%	86,36%

Note: Calculation is from year-end stock data

Source: Eesti Pank, Financial Sector Statistics, <http://www.eestipank.ee/en/statistics>

Figure 6 Structure of Lithuanian gross external debt



Notes: “Monetary financial institutions” (MFIs) are central banks, resident credit institutions as defined in Community law, and other resident financial institutions whose business is to receive deposits and/or close substitutes for deposits from entities other than MFIs and, for their own account (at least in economic terms), to grant credits and/or make investments in securities. Money market funds are also classified as MFIs.” Definition of ECB, <http://www.ecb.int/stats/money/mfi/general/html/index.en.html>

Source: Lietuvos Bankas, External statistics, http://www.lb.lt/external_statistics_1, 2013. Feb. 17.

From the menace of currency crisis, Estonia successfully ran forward into the euro zone accession in 2010, Latvia demanded 7.5 billion euro credit from IMF and EU, and Lithuania has tried to follow Estonia unsuccessfully until 2013 so far.

Fiscal stages in transition and integration

The first stage of economic transition was closed in 1999, in which period each country had to undergo considerable fiscal adjustment programs either because of internal tensions in their public finances systems or because of international financial crises. The Baltic states typically, as an aftermath of the Russian financial crisis 1998. (Benczes 2008) From fiscal aspects, the utility of this period for public finances was a chance for governments to establish a sustainable economic policy and to launch medium-term reforms in the financing systems of high volume social subsidies (and social investments). Inherited from the command economy regime, the lack of transparency was regarded by the IBRD (2004) as a number of blind spots in the fiscal framework, because budgeting and policies were completely separated and there was no medium-term planning. In addition, there existed a large number of off-budget funds, and the number of conditional obligations was also high, task- and performance-oriented financing was missing, cash-flow and debt management was fragmented, and the budget was completely input-oriented. Fiscal adjustments of the first stage created a stable starting point for Baltic countries. The following period after consolidation shall be split to two separate stages, because EU membership means stricter fiscal obligations, as these countries pledged economic policy convergence in their Accession Treaty.

The second stage of the economic policy transition lasted roughly from 1999 to 2004. In this period, candidate countries had the chance to start the creation of system of expenditures and revenues sustainable in the medium term, based on previous consolidation stage, even affording themselves a temporary growing fiscal deficit in the first years. The second stage, also, was the end of big volume of privatisation which had been part of the transition process to market economy. Consequently, large sums from selling state-owned corporations could no longer offset annual deficits and increasing public debts. Therefore, *De Novellis* and *Parlato* (2005) recommend increasing tax revenues in the post-privatisation period if the central budget had a primary deficit in the privatization stage. It did not necessarily require a tax hike! The objective could be realised by cutting back tax allowances or by broader the tax base, as was the case in the Baltic states where tax rates were even reduced besides stable revenues.

The third stage, when community expectations regarding convergence are to be met, starts with 2004. However, EU membership has meant additional challenges for economic policies beyond limitations to excessive fiscal deficit. The governments have had to contribute to the community budget and also to projects funded by community grants (Köhler-Töglhofer et al., 2003).

Fiscal positions in dynamics

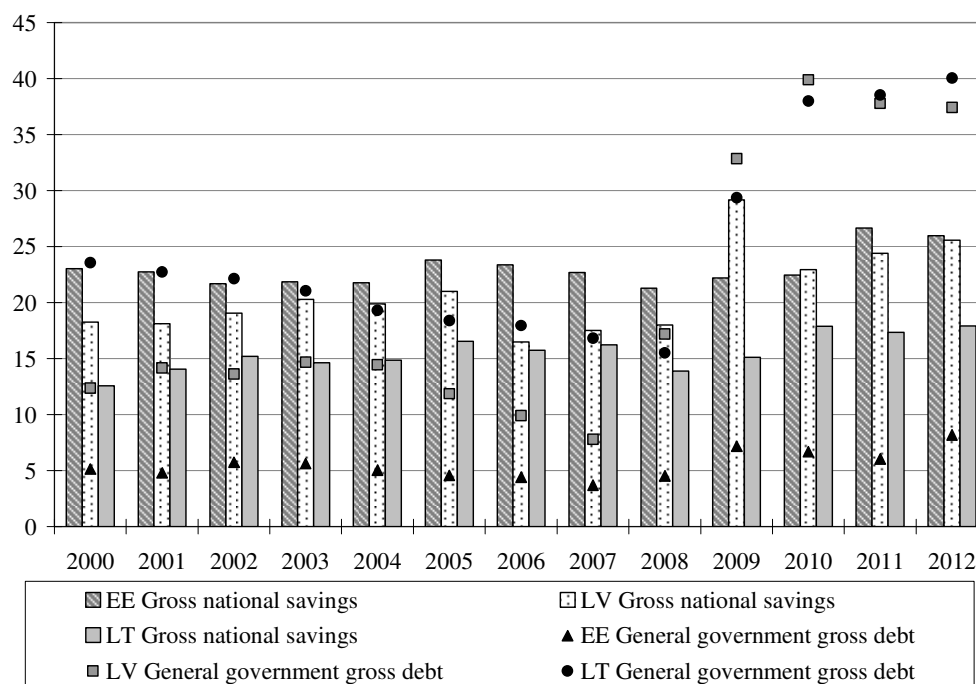
In case of the striving Baltics, the typical characteristics have been stable fiscal positions, relatively low public debt ratios compared to GDP, and low government spending.⁶

⁶ The Baltic States – had implemented flat taxes. According to *Árendás et al.*, (2006), flat taxes are fair when they reflect the socially approved level of public contribution, and at the same time are efficient and progress-safeguarding when they eliminate tax allowances and preferences, and are also simple, which ensures a higher degree of transparency and predictability for taxpayers. This latter feature is what provides a country with an edge in the tax competition that has developed among Eastern EU member states, because it can retain the volume of revenues by widening the tax base by offering certain foreign investors simpler and lower taxes.

Basically, some risks have been evident regarding price stability, but mostly on the back of global economy developments and convergence. On the one hand, energy prices were rising very dynamically in the first years of the 21st century, and on the other hand there is a serious lag behind EU15 prices and wages – with the exception of Slovenia – but economic convergence inevitably calls for rises in these scopes, too. Evidently, successful convergence requires an economic policy mixture to ensure monetary convergence for these countries. (Festič and Bekő, 2006, page 82). This is the reason for a large number of criticisms and suggestions on the part of international organisations (the IBRD, the OECD) regarding the fiscal policies of the Baltic States, because price levels are partially subject to the structure of government consumption as well as to the taxation and subsidy system which influences consumption and investment decisions of corporations and households.

In the Baltic States, one of the components of the legacy from the disintegrating Soviet Union was an extremely low level of public debt – roughly 5 % of GDP, which would have meant almost limitless fiscal opportunities in the foreseeable horizon for policy decision makers. However, the governments of the Baltic States – wisely – used this chance not to go for fiscal laxity or vote-generating subsidies but, in an example-setting manner among all the EU8+2 countries, to restructure their finance system of social benefits and to accumulate primary budget surplus. Economic growth and welfare improvement here are based on FDI influx. They had the largest manoeuvring room in their budgets among the EU27 countries in terms of fiscal balance and public debt. However, it was ruined with external imbalance. International reports – such as the ones issued by the IBRD (2007), Deutsche Bank (2006a), the IMF, the EBRD, and the European Commission – underlined external imbalance as the main risk factor.

Figure 7 Baltic gross national savings and general government gross debt, percentage in GDP, 2000-2012



Note: EE – Estonia, LV – Latvia, LT – Lithuania
Source: IMF World Economic Outlook, 2012 October

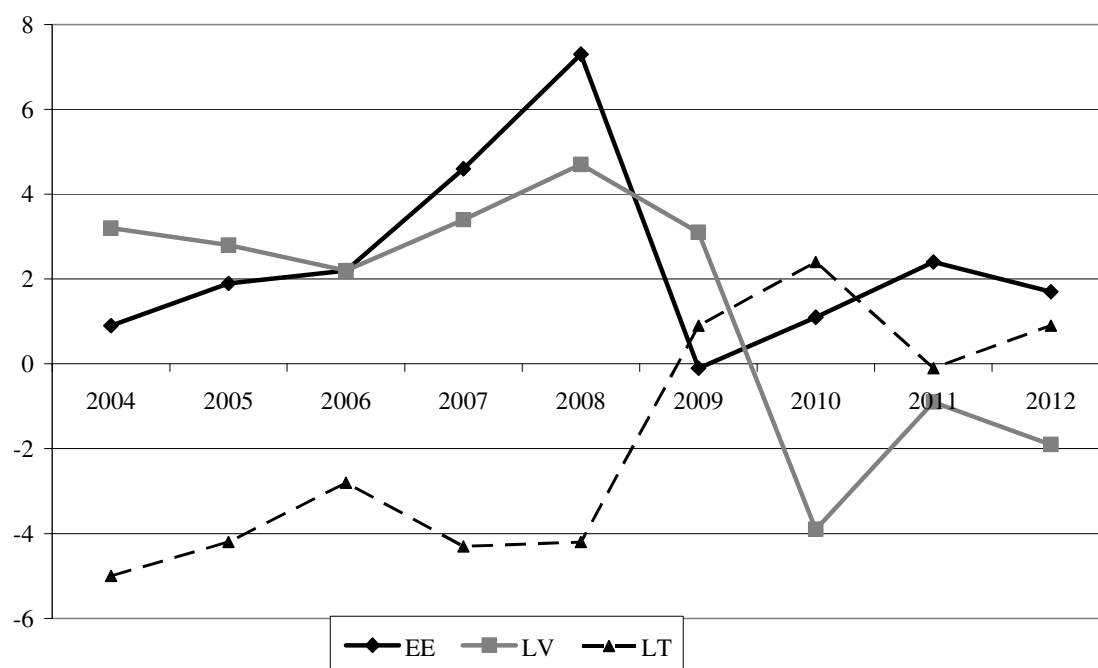
As figure 7 shows, in Latvia and Lithuania, the economic crisis shock of 2009-2010 could be treated only by sharp public indebtedness, as these two countries doubled their public debt what is not anymore covered by national savings. In this sense, the Baltic troika split. Estonia remained stable in fiscal stance and fiscal demand for debt financing has not caused significant crowding-out of private debtors from national savings. Meanwhile, Latvia and Lithuania deteriorated their fiscal room for maneuver.

4. Baltic external imbalance – proof on passive macroeconomic populism

In the followings, we will examine whether signs of macroeconomic populism, reversed Balassa-Samuelson effect and the Feldstein-Horioka puzzle is observable in the Baltic economies.

First, the inflation is analyzed, to understand that basically the currency board or narrow pegging does not automatically “import” the rate of the reference zone. In the pre-crisis period, only Lithuania could perform below the euro zone average (see figure 8). (Notice! This is not the Maastricht criterion on price stability.) This proves that Estonia and Latvia did not do every effort to keep the purchasing value of national currencies up to the power of euro. Although the global crisis years created deflation impacts, only Estonia could use it for monetary integration. As it was mentioned before, the stimulus ruined the fiscal indicators of the rest two countries. Returning to the pre-crisis deviation from average, some kind of additional inflation can be observed. In case of high growth rate years of Baltics, it would be easy to say, that it was because of a normal Balassa-Samuelson effect originated in some sort of catching up procedure and its impact on wages in tradable and non-tradable sector. But it would be hasty solution.

Figure 8 Member state deviation from euro zone average inflation (= national inflation – euro zone inflation), percentage point, euro zone = current members in a year, percentage point



Note: EE – Estonia, LV – Latvia, LT – Lithuania

Source Eurostat database, 2013. Feb. 16.

In table 3, it gets clear that the Baltic countries are uncompetitive in the trade relation with the center of EU, Germany. Increasing German surplus is recognizable from the German trade balance with chosen euro zone countries. Similar conclusion can be established from the change of terms of trade (see figure 9). The price based index expresses relative increase in export prices in the first years of Baltic membership in the EU before the crisis. The assumption is that the pegging did harm for export competitiveness.

Table 3 German trade balance with some euro zone countries, 2004-2007 and 2011

	2004	2005	2006	2007	2011
EE	342	650	954	1078	1018
LV	443	532,4	864,3	1194,3	664,6
LT	743,2	804,8	1221	1251,9	513,3

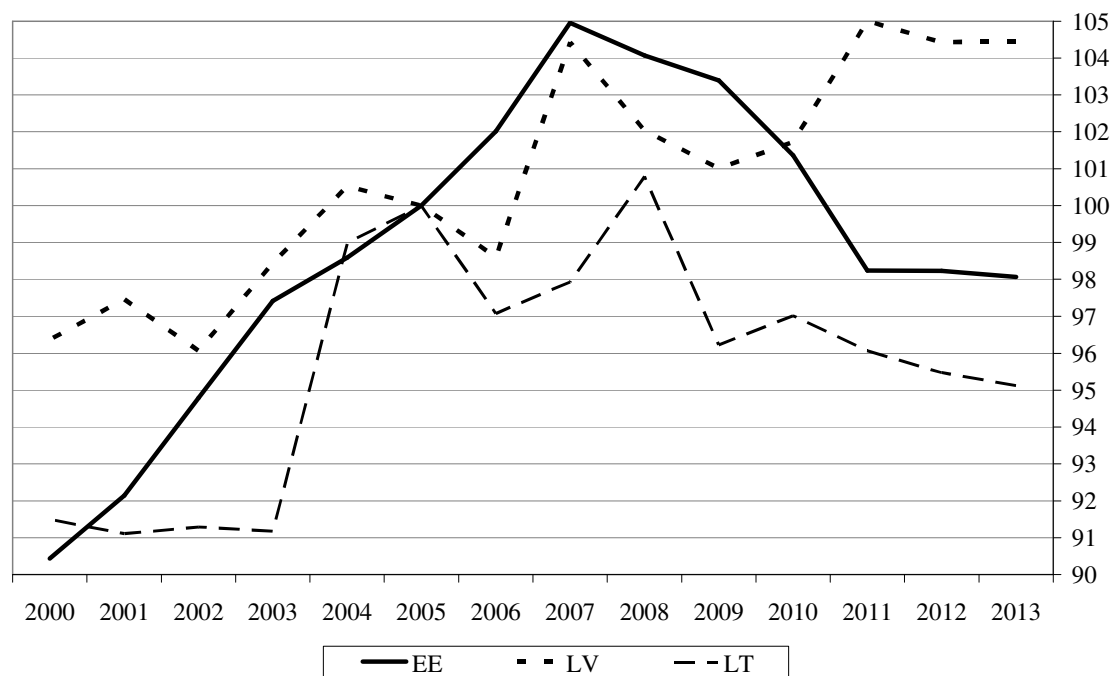
Positive value means German surplus, negative means German deficit

Source: DESTAT Statistische Jahrbuch für die Bundesrepublik Deutschland 2008 and 2012, www.destat.de

Analyzing the processes of nominal effective exchange rate (NEER, see figure 10), real effective exchange rate (REER, see figure 11) and nominal unit labour cost (ULC, see figure 12) by country, it gets clear that the growth period of Baltic EU membership of 2004-2007 resulted measurable relative appreciation of Baltic production prices and costs. The NEER and REER data series shows in comparison to the euro zone that pegged rates has been very unfavourable and disadvantageous for the Baltic region. Especially, in year of 2007 resulted sharp appreciation of REER, namely prices and wages. Appreciation means worsening competitiveness in trade and inflowing FDI.

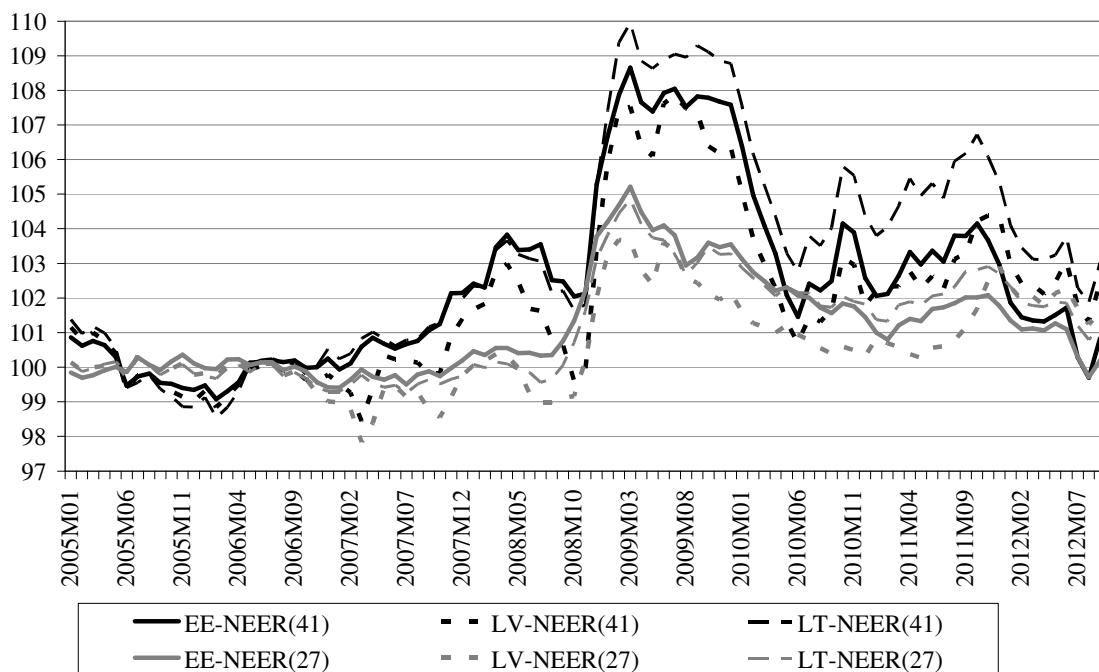
In the trends of Baltic ULC curves, all examined countries have been losing their wage competitiveness in comparison to euro zone. (Actually mostly Germany has benefited mostly from the trend of relative prices. See DG-ECFIN Price and Cost Competitiveness statistics.) The crisis years made change in the process which created imbalance. All Baltic states' NEER and REER indices have made a turn, particularly because of adjustment in public finances, nominal wages, consumption, investment and crediting. However, the monthly REER based on HICP deflator still has reserved the trend of appreciation in comparison to period of 2007 and before. The same is true for REER based on ULC – except Lithuania. The turn was established, also, in case of the analysis on current account imbalance, nevertheless, the rebalancing is far from balanced relations.

Figure 9 Terms of trade, ratio of export and import price deflators, 2005=100



Note: EE – Estonia, LV – Latvia, LT – Lithuania
Source: DG-ECFIN AMECO, 2013 Feb. 16.

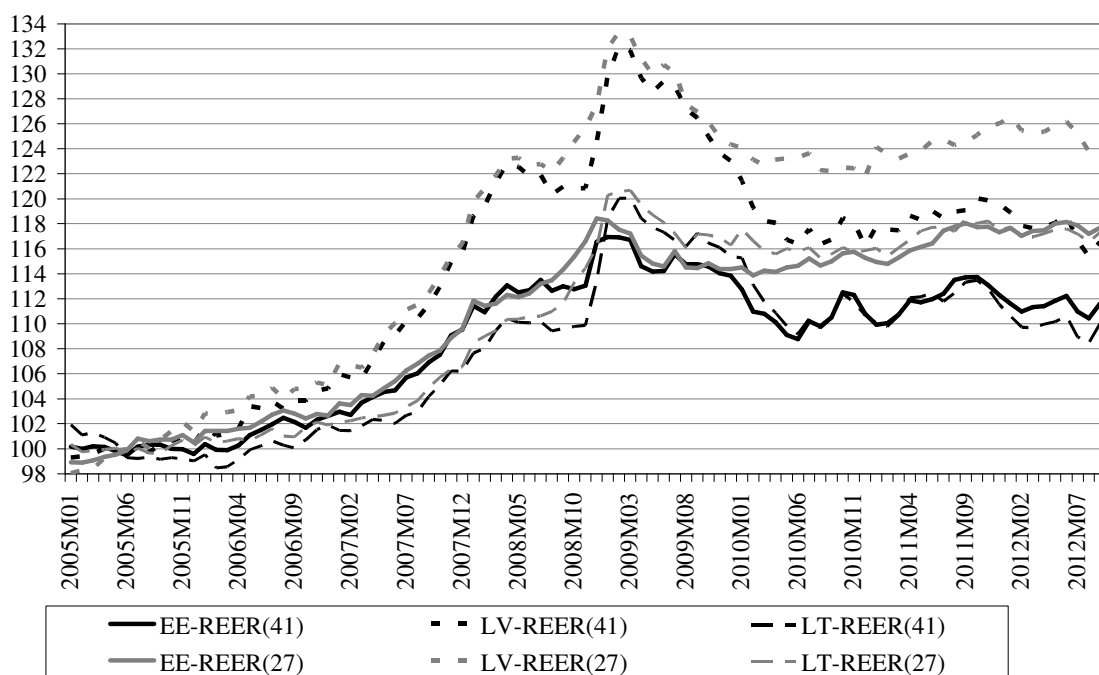
Figure 10 Monthly Nominal Effective Exchange Rate, 2005 = 100



Note: EE – Estonia, LV – Latvia, LT – Lithuania, NEER – nominal effective exchange rate, (41) – toward 41 trading partner, (27) – toward 27 trading partner

Source: Eurostat, 2013. Feb. 6.

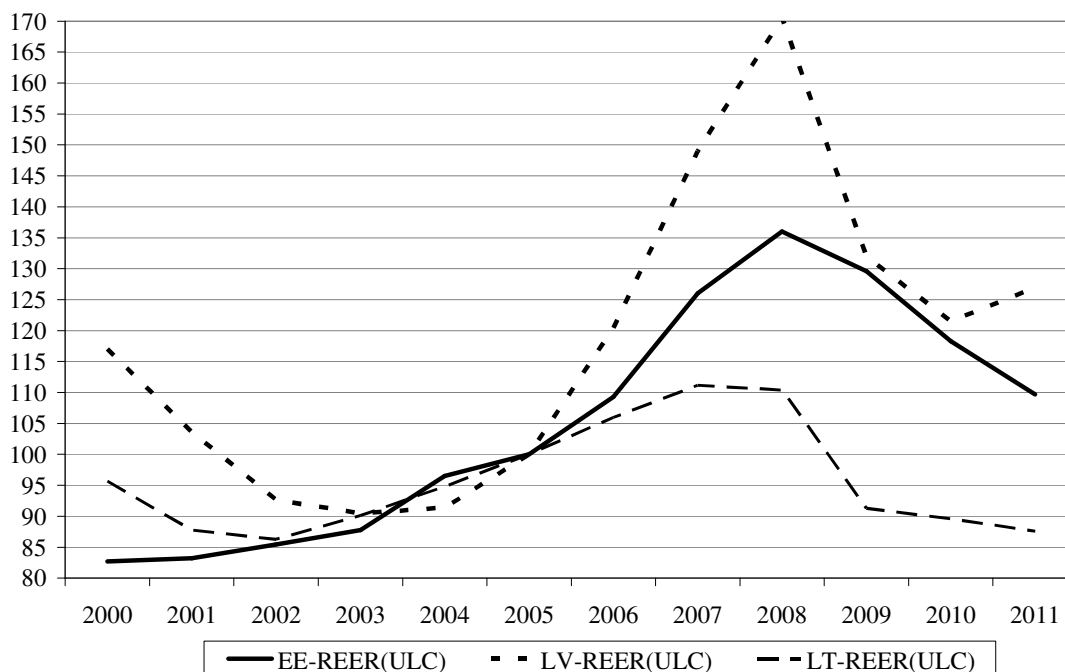
Figure 11 Monthly Real Effective Exchange Rates, HICP deflator, 2005 = 100



Note: EE – Estonia, LV – Latvia, LT – Lithuania, REER – Real effective exchange rate based on HICP deflator, (41) – toward 41 trading partner, (27) – toward 27 trading partner

Source: Eurostat, 2013. Feb. 6.

Figure 12 Annual Real Effective Exchange Rates vs. rest of euro zone, Nominal Unit Labour Cost, 2005 = 100



Note: EE – Estonia, LV – Latvia, LT – Lithuania, REER – Real effective exchange rate based on ULC,
Source: DG-ECFIN Price and Cost Competitiveness, 2012 October

5. Conclusions

In this study, the political economy model of macroeconomic populism was represented through the case study of Baltic countries. The model was supported with the economics theories of Feldstein-Horioka puzzle and reverse Balassa-Samuelson effect.

As results confirmed, the process of income growth and quick catching-up of Baltic economies were established on external financing. This phenomenon heated the non-tradable inflation as foreign savings were mostly channeled through credits and loans toward the household and corporate sectors. Finally, the external credibility of the region exhausted independently from the global recession, but not independently from the global credit money shortage. This turn caused sudden stop, which situation demanded quick and radical public and private adjustment in all of the surveyed countries.

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